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CHARLES ELMORE CROPLEY
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1932.

No. 215

E. G. PALMER,

Petitioner,

versus

MRS. AGNES B. McGRAWL, ADMINISTRATRIX OF THE ESTATE OF JACOB O. BENDER, LATE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF LOUISIANA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

and

BRIEF IN SUPPORT THEREOF.

FRED R. ANGEVINE,
JOHN H. TUCKER, JR.,
HENRY P. DART,
HENRY P. DART, JR.,
Attorneys for E. G. Palmer, Petitioner.

Montgomery-Andree Printing Co., Inc., 430-32 Chartres, N. O., La.

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Respondent.

PETITION FOR WRIT OF CERTIORARI.

May It Please the Court:

Petitioner E. G. Palmer, an individual, respectfully shows to this Honorable Court that this is a petition for a writ of certiorari to the Circuit Court of Appeals, Fifth Circuit, to review a decision made and entered by that Court on March 26, 1932 (R. 425), affirming, on the issue involved, a decision of the District Court of the United States for the Western District of Louisiana (R. 98), Petitioner filed a petition for rehearing on April 12, 1932, which was denied on April 23, 1932 (R. 438).

A.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

1. History of Case.

This case involves income taxes for the years 1921 and 1922. Petitioner, pursuant to assessment and demand from the Collector, paid certain additional income taxes, and filed claims for refund which were denied (R. 54). Suit for recovery was instituted in the United States District Court for the Western District of Louisiana on December 20, 1929, which Court on March 4, 1931, rendered its decision denying recovery on the issue of depletion involved, and allowing recovery on the question whether a certain payment by the Gulf Refining Company in 1921 constituted taxable income to a partnership of which petitioner was a member (R. 98-115).

An appeal and a cross appeal were taken by petitioner and the Collector of Internal Revenue, respectively, to the Circuit Court of Appeals, Fifth Circuit, and that Court on March 28, 1932, handed down its decision affirming the District Court on both points. Rehearing was denied to petitioner (R. 438).

After the rendition of the judgment in the District Court the defendant Collector died and his administratrix, Mrs. Agnes B. McGrawl Bender, was properly substituted appellee and appellant respectively and it was ordered by the court that the case proceed thenceforth in the name of said substituted appellee and appellant. (R. 422-3).

2. Facts Involved.

A partnership called J. E. Smitherman, Special Account, of which petitioner E. G. Palmer is a member, discovered oil on a large tract near Haynesville, Louisiana, by drilling and completing the first producing well thereon on March 30, 1921 (R. 31). The partnership was lessee of the land. Prior to this date no oil had been discovered within 12 miles of the tract (R. 31). The fair market value of the property at the date of discovery or within 30 days thereafter was substantial and was materially disproportionate to cost (R. 51).

In computing his net income from the property, petitioner, as a member of the partnership and as lessee and discoverer, was entitled, under the existing Revenue Law, to depletion deductions based on the value of the property at the time of the discovery or within 30 days thereafter. *Section 214 (a) 10, Revenue Act of 1921,* provides in part as follows:

> "(a) That in computing net income there shall be allowed as deductions:
>
> (10) In the case of mines, oil and gas wells, * * * a reasonable allowance for depletion * * *, according to the peculiar conditions in each case * * *: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: * * * In the case of leases the deductions allowed by this paragraph

shall be equitably apportioned between the lessor and lessee."

Within 30 days after the discovery, the partnership transferred leases affecting 120 acres adjacent to the discovery well to the Ohio Oil Company for $3,000,000 cash and $1,000,000 to be paid out of oil, the partnership reserving besides one-eighth of the oil to be produced from the property as an overriding or excess royalty (R. 31).

The partnership treated the agreement with the Ohio Oil Company as a sublease, the one-eighth excess royalty as rental, and the payments of $3,000,000 cash and $1,000,000 out of oil as bonuses or advance royalties paid by the Ohio Oil Company to secure the sublease (R. 49-51). The nature of the payments made by the Ohio Oil Company and the deductions for depletion therefrom in arriving at the net income of the partnership is the matter primarily involved here. The Regulations of the Treasury Department then in existence *(Article 215 (a), Regulations 45, 1920 Edition)* provided for depletion deductions by a lessor against bonuses or advance royalties, which regulation was as follows:

> **"Depletion—Adjustments of accounts based on bonus or advanced royalty.** (a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the differ-

> ence may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Article 215 (a) of Regulations 62 applying the 1921 Revenue Act was identical with the above.

The partnership of which petitioner was a member took such authorized deductions against the bonuses or advance royalties in computing the distributive net income of the partnership for the years 1921 and 1922. Petitioner in his personal returns reported his share of such distributive net income of the partnership (R. 322).

In November, 1926, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, amended *Article 215 (a) of Regulations 45 and 62, supra*, by Treasury Decision 3938, C. B. Dec. 1926, p. 117, which is as follows:

> "(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

On audit of petitioner's returns the Commissioner of Internal Revenue disallowed the depletion deductions

against the $3,000,000 and $1,000,000 payments made by the Ohio Oil Company on the ground that the agreement between the partnership and the Ohio Oil Company constituted a sale and not a sublease, and that the payments of $3,000,000 cash and $1,000,000 out of oil constituted the consideration paid by the Ohio Oil Company for the lease. As a result of such disallowance the additional taxes in controversy here were then assessed and collected by the Treasury Department. Claims for refund by the petitioner were made by using the formula in the amended regulation, *supra*, (Treasury Decision 3938) in computing the depletion deductions.

The District Court for the Western District of Louisiana upheld the Commissioner of Internal Revenue on the question of sale or sublease on the authority of *Waller v. Commissioner, 40 F. (2d) 892.* The District Court expressed considerable doubt as to the correctness of its ruling in view of the case of *Smith v. Sun Oil Co., 165 La. 907,* decided by the Supreme Court of Louisiana, distinguishing a sublease from an assignment in that State (R. 98-114), but felt constrained to follow the decision in *Waller v. Commissioner, supra.*

The Circuit Court of Appeals, while apparently upholding the Commissioner and its own former decisions on the question of a sale or sublease, appears to base its decision denying depletion to the petitioner, primarily, on the ground that Article 215 (a) of Regulations 45 and 62, as amended by Treasury Decision 3938, is not a reason-

able application of the depletion provisions of the Revenue Laws. The Court said in part:

> "But even if appellant (Palmer) occupied the position of a sublessor, there is a broader ground upon which in our opinion the judgment against him should be upheld. * * * We have no hesitation in saying that in our opinion he is not equitably entitled to allowances for depletion based on the so-called advance royalties, or money payments, or on ⅞ths of the oil produced." (R. 425).

The above language is tantamount to holding that the regulation in question is not a reasonable interpretation of the provision of the Revenue Law providing for depletion deductions on discovery revaluation.

Petitioner was also a member of the George O. Baird partnership, wherein a similar question of sale or sublease was presented (R. 98-108). The facts with respect to the Baird partnership were stipulated (R. 92), and are not set forth here, as a decision on the facts of the Smitherman partnership would be determinative of that issue also.

3. Questions Involved.

(1) Due to the language of the Circuit Court of Appeals holding that petitioner is not entitled to allowances for depletion based on the advanced royalties, the primary question here is whether Article 215 (a) of Regulations 62, as amended by Treasury Decision 3938, is a reasonable and proper application of Section 214 (a) of the Revenue Act of 1921.

(2) Were the transfers of the oil and gas leases from Smitherman to the Ohio Oil Company and from

Baird to the Gulf Refining Company sales (assignments) or sub-leases?

(3) If sub-leases, was the petitioner as sub-lessor entitled to deductions for depletion based upon discovery value as of the basic date on the bonus, advanced royalties or other sums received thereunder?

B.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

1. In its disapproval of Article 215 (a), Regulations 45 and 62, as amended, the opinion of the Circuit Court of Appeals is in direct conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in the case of *Murphy Oil Company v. Burnet, 55 F. (2d) 17*, decided January 11, 1932. That court in the *Murphy Oil Company* case expressly approves the identical regulation, saying, in part (p. 25):

> "The regulation is not only not in conflict with the statute, but directly conforms thereto."

In the *Murphy* case, the "basic date" for revaluation for depletion purposes was March 1, 1913, the lease having been acquired prior to that date. In this case the "basic date" for revaluation for the same purpose was March 30, 1921, the date of the discovery of oil.

If such a conflict between two U. S. Circuit Courts of Appeals were permitted to continue, it would result in great uncertainty and confusion in the administration of

the income tax laws and gross injustice to the citizens adversely affected.

Petition for writ of certiorari in *Murphy Oil Co. v. Burnet, Commissioner of Internal Revenue*, No. 955 of the docket of this Honorable Court was granted on May 31, 1932.

2. The Circuit Court of Appeals, in disapproving the regulation, decided an important question of Federal income tax law, which has not been but should be settled by this court. Depletion deductions against advance royalties, bonuses or money payments in connection with oil and gas leases have been provided for by Treasury regulations at all times since the 1918 Revenue Act. It is true that Article 215 (a) of Regulations 45 and 62 promulgated originally under the 1918 and 1921 Revenue Acts, respectively, was amended in 1926 by Treasury Decision 3938, which provided a somewhat different formula for computing the deduction. However, the principle involved, namely, that where the royalty is anticipated, the deduction should also be anticipated, has remained the same. Successive Revenue Acts have been passed during the existence of the regulation, thus evidencing Congressional approval.

The regulation is a reasonable and proper one in that it correlates gross income of oil or gas properties and the depletion deductions therefrom, and thus prevents a distortion of net income. Depletion based on discovery

valuation was a statutory grant by Congress to the oil and gas industry. Advance royalties in the nature of cash bonuses or lump sum advance payments are common in the leasing and subleasing of oil and gas properties. This Court has held that such cash bonuses or advance royalties are just as much royalties as the stipulated regular royalties paid with relation to the production *(Work v. Mosier, 261 U. S. 352, 357-358)*. The Revenue Act provides that depletion shall be "equitably apportioned between the lessor and the lessee" *(Section 214 (a) (10), Revenue Act of 1921)*.

Where the royalties are paid to the lessor in advance of actual production, there can be no equitable apportionment of the depletion deduction to the lessor, if he is not able to take the deduction in the same year he received the advance payments. Such circumstances gave rise to the regulation here in question.

In his brief below, respondent conceded the applicability of the Regulations to sub-lessors.

The Commissioner of Internal Revenue was given specific authority in the Revenue Act to promulgate regulations concerning depletion deductions on oil and gas properties. The regulation in question was a proper exercise of that authority. Of necessity much latitude was given to the administrative officers charged with the duty of enforcing the law. Their interpretation of the statute should not be interfered with, unless clearly unlawful *(Lucas v. American Code Co., 280 U. S. 445)*.

3. The question of the nature of the transfers here involved was presented to the Circuit Court of Appeals for the Fifth Circuit in *Waller v. Commissioner, 40 F. (2) 892* and *Herold v. Commissioner, 42 F. (2) 943.* In *Waller v. Commissioner* the government conceded the right to depletion if the transfer was a sublease *(16 B. T. A. 574).* They were held in those cases to be sales or assignments and not subleases. Petition to this court for writ of certiorari in the *Waller* case was denied. No such petition was presented in the *Herold* case. Since the date of the decisions in those cases, and the refusal of the writ in the *Waller* case, the Supreme Court of Louisiana has had occasion to review the entire jurisprudence of the State on the question in *Roberson v. Pioneer Gas Co., 173 La. 313 (137 So. 46)* and has restated it in a manner diametrically opposed to the construction of the Circuit Court of Appeals in those cases and in the present controversy. The decisions of the Circuit Court are postulated on common law definitions taken from common law encyclopedia which are unsupported by the citation of Louisiana authorities. Such is in direct conflict with the decision of this court in *Viterbo v. Friedlander, 120 U. S. 707,* wherein the fundamental, basic difference between the common law and the civil law conceptions of lease was so graphically stated as to preclude the consideration of common law authorities with reference to Louisiana leases.

The decision of the Circuit Court of Appeals in this case, following its pronouncements in *Waller v. Commissioner* and *Herold v. Commissioner,* both *supra,* is in di-

rect conflict with the Revised Civil Code of Louisiana, as interpreted and applied by the Supreme Court of Louisiana.

In the above cases, the Circuit Court of Appeals held the retention of a reversion to be necessary to characterize the transfer of a lease as a sublease, the common law test. In *Roberson v. Pioneer Gas Co., 173 La. 313 (137 So. 46)* the Supreme Court of Louisiana restating and reaffirming the doctrine of *Smith v. Sun Oil Co., 165 La. 907* and *Johnson v. Moody, 168 La. 799*, said the stipulation for a new rental characterized the transfer of a lease as a sublease and that the retention of an over-riding royalty in the transfer of an oil lease was the stipulation for a new rental, citing *Spence v. Lucas, 138 La. 763; Logan v. State Gravel Co., 158 La. 105; Board of Commissioners v. Pure Oil Co., 167 La. 801.* The Circuit Court of Appeals sought to distinguish these authorities by saying royalty, payable in oil, might be, and was in this case, not rent, but a part of the purchase price. No cogent reasons were assigned for this statement and it was supported by the citation of only one case in Louisiana jurisprudence, the case of *Wilkins v. Nelson, 155 La. 808*, which was incorrectly cited. In *Herold v. Commissioner, 42 F. (2) 942*, the court cited *Wilkins v. Nelson, 155 La. 808*, as holding royalty may form part of the consideration for mineral rights. In *Wilkins v. Nelson, 161 La. 437*, the Supreme Court of Louisiana said "the mineral contract in question was declared to be a lease in *Wilkins v. Nelson, 155 La. 810.*" Moreover, Articles 2439 and 2464, Revised Civil Code of Louisiana, require the price of a sale to be a certain sum payable in current money while Article 2671, Revised Civil

Code, permits the price of a lease to "consist of a certain quantity of commodities or even of a portion of the fruits yielded by the thing leased."

The decision in the case therefore is basically and diametrically opposed to the entire jurisprudence of Louisiana; to the applicable provisions of the Civil Code of that State, and to the entire civil law philosophical concept of lease. To determine this particular question, the Circuit Court of Appeals has decided a question of local Louisiana law, affecting Louisiana citizens and Louisiana property, contrary to the Louisiana law and jurisprudence; and by reference to a system of laws held by this Honorable Court to be inapplicable to the subject matter in Louisiana. *(Viterbo v. Friedlander, supra).*

WHEREFORE your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals of the Fifth Circuit commanding that court to certify and send to this court for its review and determination on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket No. 6409 E. G. Palmer v. Jacob O. Bender, individually and as Collector of Internal Revenue for the District of Louisiana, and that the judgment of the Circuit Court of Appeals for the Fifth Circuit may be reversed in so far as it denies plaintiffs the relief therein sought and the cause be ordered remanded to be remanded to the United States District Court with instructions to compute and enter judgment for petitioner, allowing additional deductions for depletion in

respect of the bonuses or advanced royalties received by the Smitherman and Baird partnerships, such deductions to be based upon the discovery revaluation of the properties and computed under the formula provided in the amended regulations, and that your petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just; and your petitioner will ever pray.

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Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

I.

OPINION BELOW.

The opinion of the Circuit Court of Appeals for the Fifth Circuit is reported in *57 F. (2) 32.*

II.

JURISDICTION.

The jurisdiction of this court is invoked on the following grounds:

(1) The judgment to be reviewed was originally entered March 26th, 1932 (R. 425). The taxpayer filed a petition for rehearing which was submitted on April 12, 1932, and denied April 23, 1932 (R. 438).

Time to apply for a writ of certiorari, therefore, runs from April 23, 1932 *(Citizens Bank of Michigan v. Apperman, 249 U. S. 448, 450; Morse v. United States, 270 U. S. 151.*

2. The United States District Court had jurisdiction of this case under Section 1113, Revenue Act of 1926 *(Sec. 3226 of Revised Statutes as amended).* The appeals to the United States Circuit Court of Appeals were taken in pursuance of the provisions of Section 128 of the Judicial Code.

3. This court has jurisdiction to review the judgment of the Circuit Court of Appeals. *Judicial Code, Sec. 240)* (a) as amended by Act of February 13, 1925. The Circuit Court of Appeals has rendered a decision in conflict with the decision of another Circuit Court of Appeals on the same matter, to-wit, the decision of the Ninth Circuit in the case of *Murphy Oil Co. v. Burnet, 55 Fed. (2d) 17,* and has also decided an important question of local law in conflict with applicable local decisions, to-wit, the decisions of the Supreme Court of Louisiana in the cases of *Roberson v. Pioneer Gas Co., 173 La. 313, 137 So. Rep.*

46; Smith v. Sun Oil Co., 165 La. 907, 116 So. 379, 380; Johnson v. Moody, 168 La. 799, 123 So. 330. The Circuit Court of Appeals has also decided an important question of Federal Income Tax Law which has not been and should be settled by this court.

III.

QUESTIONS INVOLVED.

The primary question presented by the decision of the Circuit Court of Appeals for the Fifth Circuit in the instant case is whether petitioner is entitled to depletion deductions in respect of the bonus or advanced royalty in accordance with the Treasury regulations; the decision of that Court in refusing such allowance having squarely placed at issue the validity of *Article 215 (a)* of Regulations 62, as amended by Treasury Decision 3938, as reasonable and proper application of *Section 214 (a)* of the Revenue Act of 1921.

There is likewise presented the question of the nature of the transfers of the oil and gas leases involved. Petitioner contends they were sub-leases; the Government contends they were sales or assignments. In its decision in this case the Circuit Court of Appeals intimates that it would adhere to its decisions on that question in *Waller v. Commissioner, 40 F. (2d) 896,* and *Herold v. Commissioner, 42 F. (2d) 942,* in spite of the decision of the Supreme Court of Louisiana in *Roberson v. Pioneer Gas Co., 173 La. 313,* decided subsequent to those two cases, in a manner directly opposed to the rulings in those cases on that point. Petitioner contends that the decisions of the Circuit Court of Appeals on that question are wholly at

variance with the statutes and jurisprudence of Louisiana, are incompatible with the civil law concept of lease, and are based on definitions taken from the common law, which this Honorable Court has rejected as inapplicable to a consideration of leases in Louisiana, and without the support of a single case decided by the Supreme Court of Louisiana.

IV.

SPECIFICATIONS OF ERROR.

(1)

That the United States Circuit Court of Appeals erred in disapproving Article 215 (a), Treasury Regulations 62, as amended by Treasury Decision 3938.

(2)

That the said Court erred in not holding that Article 215 (a), Treasury Regulations 62, as amended by Treasury Decision 3938, constitutes a proper interpretation and application of the depletion provisions of the 1921 Revenue Act.

(3)

That the said Court erred in not holding that petitioner as a member of the Smitherman partnership and Baird partnership, was entitled to depletion deductions in 1921 and 1922 with respect to the bonuses or advanced royalties received by those partnerships.

(4)

That the said Court erred in denying petitioner's claim for refund, which claimed refund was based on de-

pletion deductions with respect to the bonuses or advanced royalties received by the partnerships.

(5)

That the said Court erred in holding the contract between James E. Smitherman and the Ohio Oil Company, dated April 23, 1921 (Exhibit N, R. 242) and the contract between George O. Baird and the Gulf Refining Company, dated November 26, 1921 (Exhibit Y, R. 313) to be sales or assignments, and in not holding them to be sub-leases.

(6)

That the said Court erred in not construing those contracts according to the Civil Law of Louisiana, as distinguished from the Common Law, and in not following the jurisprudence of Louisiana as reaffirmed in *Roberson v. Pioneer Gas Co., 173 La. 313, 137 So. Rep. 46.*

(7)

That the said Court erred in not giving effect to the doctrine of *Roberson v. Pioneer Gas Company, supra,* as to the distinction between sub-leases and assignments.

(8)

That the said Court erred in holding the over-riding or excess royalty respectively reserved by Smitherman and Baird in the aforesaid contracts to be part of the purchase price of a sale.

(9)

That the said Court erred in not holding such excess royalties to be rent, as established by the Revised Civil Code of Louisiana and the jurisprudence of the Supreme

Court interpretative thereof; and particularly *Revised Civil Code, Articles 2439, 2464* and *2671*, and *Logan v. State Gravel Co., 158 La. 105; Board of Commissioners v. Pure Oil Co., 167 La. 801; Wilkins v. Nelson, 161 La. 437.*

(10)

That the said Court erred in holding the failure of the Ohio Oil Company and the Gulf Refining Company to respectively pay Smitherman and Baird the over-riding or excess royalties retained by them would not entail forfeiture of the rights of the Ohio and Gulf companies under the said contracts; which ruling of the Court is in direct conflict with the Revised Civil Code of Louisiana and the interpretative jurisprudence of the Supreme Court of Louisiana, particularly, *Revised Civil Code, Article 2712* and *Louisiana Oil Refining Corporation v. Cozart, 163 La. 90.*

(11)

That the said Court erred in holding that even if the instruments in question constituted sub-leases, the petitioner, as a member of the Smitherman and Baird partnerships, discoverers of the oil wells in question, would not be entitled to depletion deductions based on discovery revaluation, said deductions to be taken against the bonuses or advanced royalties received.

(12)

That the Circuit Court of Appeals erred in not reversing the decree of the District Court and in not remanding the case with instructions to render judgment in favor of the petitioner as prayed for.

ARGUMENT.

I.

Article 215 (a), Regulations 62, as amended, is a reasonable interpretation and application of the depletion provisions of the Revenue Act of 1921, and should not be disturbed.

This case involves the validity of a Treasury Regulation with respect to deductions for depletion in arriving at the taxable net income of petitioner. The facts concerning the Smitherman partnership, of which petitioner was a member, have heretofore been set out briefly at page 3 of the petition. The pertinent portions of the Regulations, both as originally promulgated and as later amended, are set forth at pages 4-5 of the petition. The income taxes sought to be recovered are for the years 1921 and 1922, and were collected under the 1921 Revenue Act. The original Regulation *(Article 215 (a), Regulations 62)* was in effect when petitioner made his return, and the deductions for depletion were taken thereunder. At the time this suit was brought in the District Court below the Regulation had been amended by Treasury Decision 3938. Therefore, in the District Court petitioner sought recovery of the taxes on the basis of the amended Regulations, and it is this interpretation of the Revenue Act by this Department which is here involved.

The transactions concerning the leases were carried out by the Smitherman partnership, of which petitioner was a member. Inasmuch as a partnership is not a taxable entity separate from its members under the 1921

Revenue Act, reference hereafter will be made only to petitioner.

Petitioner and his associates in 1921 discovered oil on a large tract near Haynesville, Louisiana, of which they were lessees. The fact that petitioner was a discoverer places him in a special category for the purpose of computing his net income derived from the oil property. *Section 214 (a) of the Revenue Act of 1921* provides as follows:

> "That in computing net income there shall be allowed as deductions:
>
> "(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case * * *: *Provided further*, that in the case of mines, *oil* and gas *wells, discovered by the taxpayer*, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease: where the fair market value of the property is materially disproportionate to the cost, *the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter;* such reasonable allowance in all the above cases to be made under the rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee. * * *." (Italics supplied).

It will be seen from the above that petitioner as discoverer was entitled to deductions for depletion based on the fair market value of the property at the time of the discovery or within 30 days thereafter, there being no question but

that such fair market value was materially disproportionate to cost.

Prior to the transaction with the Ohio Oil Company petitioner and his associates as primitive lessees were entitled to ⅞ths of the oil, while the lessors (landowners) were entitled to ⅛th of the oil. Section 214, *supra*, provides for an equitable apportionment of the depletion deduction between the lessee and the lessor. Such equitable apportionment of the deduction between petitioner and his lessors was to be made under Regulations of the Commissioner of Internal Revenue.

Such was the situation at the time of the discovery of the well. Within a month thereafter petitioner and his associates entered into an agreement with the Ohio Oil Company wherein the Ohio Oil Company paid the partnership $3,000,000 in cash, agreed to pay $1,000,000 out of oil and agreed further to pay over and deliver one-eighth of the oil produced and saved from the leased premises as an excess or over-riding royalty as long as the property produced oil in paying quantities.

It is assumed for this part of the brief that the contract with the Ohio Oil Company constituted a sublease, the ⅛th royalty being rent and the payments of $3,000,000 and $1,000,000 being bonuses or advance royalties paid to secure the sublease.

The original Regulation *(Article 215 (a), Regulations 62)* was in existence at the time petitioner made his return. This Regulation authorized a taxpayer to take depletion deductions against bonuses or advance royalties, and petitioner took such deductions in his original return.

These deductions were disallowed, and additional taxes were paid under protest, pursuant to such disallowance. Meanwhile, the Regulation was amended so as to change the formula for computing the deduction. The refund claim and suit in the District Court below were based on a recomputation of taxes on the basis of such amended Regulation. The Circuit Court of Appeals in its opinion disapproved the amended Regulation for reasons hereinafter discussed.

Thus the question presented is whether the Regulation is a reasonable application and interpretation of the depletion provisions of the Revenue Law.

(1) Opinion of Circuit Court of Appeals.

The Circuit Court of Appeals disapproved the Regulation in question, and denied the depletion deductions to petitioner. The opinion states in part:

> "But even if appellant (Palmer) occupied the position of a sublessor, there is a broader ground upon which in our opinion the judgment against him should be upheld. * * * We have no hesitation in saying that in our opinion he is not equitably entitled to allowances for depletion based on the so-called advance royalties, or money payments, or on 7/8ths of the oil produced." (R. 425).

The reasons assigned by the court for holding the Regulation invalid are unique, and as will be seen, the court in its opinion overlooked pertinent provisions of the 1921 Revenue Act. The opinion states in part:

> "It is not reasonable to suppose that either the Ohio Oil Co. or the Gulf Refining Co. should surrender the benefit of the depletion allowance on

$4,000,000 in the one case and $325,000 in the other."

Later in the opinion it is stated:

"It is almost inconceivable that it was the intention of Congress to withhold an allowance for depletion from the operator of an oil and gas lease who produces all the oil and upon the production of which he owns the greatest portion, and grant it to the holder of an overriding * * * royalty."

In other words, according to the opinion, an allowance of the deduction to petitioner would have the effect of denying depletion deductions to the Ohio Oil Company as sublessee. However, such is not the case. The Ohio Oil Company came on the scene as sublessee **after** the discovery, and any interest it acquired was in a proven property in the form of a producing well. Not being the taxpayer who discovered the property, the Ohio Oil Company was not entitled to depletion based on the fair market value of the property at the time of discovery. Its basis for depletion was cost. *Section 214 (a) (10) of the Revenue Act of 1921* contains the following provision:

"In the case of mines, **oil** and gas **wells**, other natural deposits, and timber, a reasonable allowance for depletion, and for depreciation of improvements, according to the peculiar conditions in each case, **based upon cost**, including cost of development not otherwise deducted."

The Commissioner of Internal Revenue in *Article 203 of Regulations 62* provides in subsection (d) as follows:

"The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost."

It appears clear from the above that the basis for petitioner's depletion and the basis for the Ohio Company's depletion are entirely different. One bears no relation whatsoever to the other. In order to be entitled to depletion based on discovery value, the taxpayer must be the discoverer or his lessor at the time of discovery. Under the law only those who stood in the position of lessee or lessor at the time of discovery are entitled to depletion based on discovery revaluation. The Circuit Court of Appeals below is, therefore, clearly in error, having apparently overlooked the plain wording of the statute which provides cost as the depletion basis for a taxpayer who becomes a lessee subsequent to discovery.

The only other decisions which consider the validity of the Regulation are those of the Board of Tax Appeals and the Circuit Court of Appeals for the Ninth Circuit in the case of *Murphy Oil Company v. Commissioner, 15 B. T. A. 1203, 55 Fed. (2) 17,* (certiorari granted May 31, 1932).

(2) Murphy Oil Company Case.

In the case of *Murphy Oil Company v. Commissioner* the Board of Tax Appeals disapproved the Regulation in question on an entirely different ground *(15 B. T. A. 1203)*. The Board there held that the depletion deduction can be measured only by the oil produced, and that any depletion allowance against bonuses or advance royalties is a departure from the depletion concept.

The *Murphy Oil Company* case was taken to the Circuit Court of Appeals for the Ninth Circuit. That court considered at length the identical regulation concerning

allowances for depletion against bonuses or advance royalties. The court reversed the Board, and said in part as follows, *55 Fed. (2) 17:*

> "The position of the board in this case is to the effect that the bonus does not come within the provisions of the statute in reference to capital gain and that it must therefore be treated as income notwithstanding the provisions of the statute and of the regulations regarding depletion allowances. It will also be observed that the board classified bonus as identical with royalty oil and that neither could justly be regarded as return of capital, while the whole theory of the depletion allowance is that the proceeds derived from the sale of royalty oil is of necessity in part a return of capital. It is the only manner in which the capital represented by the oil will be returned to the lessor, and for that reason is subject to a depletion allowance. The depletion allowance under the ruling of the commissioner in this case was made to the taxpayer upon the theory that although its royalty amounted to over two million dollars a large portion of that royalty constituted a return of capital which was allowed to it under the statute to compensate for the depletion of its oil reserve. The question in this case is the amount per barrel to be allowed to the petitioner as its returned capital and this must be determined by ascertaining, as the law provides, the fair market value of the property on March 1, 1913, and by allowing a reasonable allowance for depletion based in part upon that property value. The theory upon which the commissioner has proceeded in fixing petitioner's tax under the regulations of the Treasury Department is that the taxpayer is entitled to the return of his entire capital in the form of bonuses and royalties, and that his liability for tax upon the income is upon the balance of the income derived from the property after deducting the installment of capital included in the royalty oil. *The regula-*

tion is not only not in conflict with the statute, but directly conforms thereto. The statute with reference to depletion of oil properties is a special one with reference to the particular subject of oil leases involving the production of oil and minerals from mines, and the consequent return of capital by the owners of interests therein, and controls over other general provisions of the law in regard to the return of capital investments." (Italics supplied).

The above language clearly approves and upholds the Regulation in question. The Commissioner of Internal Revenue in that case made the same contention that petitioner is making here as to the validity of the Regulation.

(3) The Regulation is a proper application of the depletion provision.

Both the 1918 and the 1921 Revenue Acts gave the Commissioner of Internal Revenue specific authority to promulgate regulations under which depletion deductions were to be taken. Bonuses or lump sum advance payments for oil or gas leases are common in the oil industry. This Court has held that such payments are just as much royalties as the regular stipulated royalties paid with relation to production *(Work v. Mosier, 261 U. S. 352, 357-358).* When a lessor or sublessor receives such advance royalties they, as well as the regular royalties, are considered income from the use of the property *(Von Baumbach v. Sargent Land Company, 242 U. S. 503).* While such royalties are income, they are, nevertheless, gross income subject to any legal deduction in arriving at net income.

Depletion deductions for income tax purposes are of statutory conception and not of economic conception. A

taxpayer has no inherent right to depletion deductions, and if Congress had not granted the deduction, the entire income from operation of mineral properties would be taxable *(Stratton's Independence v. Howbert, 231 U. S. 399)*. Since depletion is purely a grant from Congress, the sole question here is one of construction of the depletion provisions of the Act and the validity of the Regulations specifically authorized by those provisions for the allowance of the deductions.

The amended Regulation in question proceeds on the same concept of a bonus as expressed by this Court in *Work v. Mosier, supra*, to-wit, that it is an advance royalty. The Regulation provides that the depletion deduction with respect to cash bonuses shall be an amount equal to that proportion of the basic value which the amount of the bonus bears to the sum of the bonuses or royalties expected to be received. This formula provides that the deductions shall be in direct proportion to and limited by the mineral content of the property. The bonus is in direct payment of the resources to be exhausted, being part of the royalty or rent paid therefor. Ordinarily both the royalty and the depletion deduction are measured by the actual exhaustion of the mineral content. Where, however, the royalty is paid partly in advance of the removal of the mineral content, the depletion deduction should likewise be taken partly in advance. In other words, the deduction should be correlated with the gross income in order to arrive at net income. This does not mean that the depletion deduction against the cash bonus prior to removal of the oil bears no relation to the mineral content to be removed. The deduction is directly related to and

limited by the basic value of the mineral to be exhausted. The allowances are so related that the total deductions cannot in the aggregate exceed the basic value. Thus the Regulation provides in part *(Article 215 (b), Regulations 62)*:

> "* * * no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made."

The Regulation also provides in extraordinary circumstances for the restoration to the capital account of depletion deductions allowed in excess of actual extraction of the mineral. The Regulation states:

> "(c) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.
>
> "(d) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the

corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned."

The Regulation, therefore, is no departure from the depletion concept in that the deductions are limited by and directly related to the exhaustion of the minerals. Indeed the Regulation provides a reasonable and equitable means of co-ordinating the deduction with the income received in point of time. Correlating the gross income with the deduction prevents a distortion of net income. This is illustrated in the case at bar. Petitioner as discoverer was entitled to deductions based on 7/8ths of the fair market value of the property at the time of discovery. He and his associates subleased the property to the Ohio Company in 1921 and received advance royalties or bonuses in the amount of approximately $4,000,000. To deny him the allowance in 1921 as deductions against the $4,000,000 gross income from the use of the property that year, would result in a clear distortion of income. Furthermore, it might well result in disallowing the deduction almost entirely, as there would be no other year in which petitioner would receive sufficient gross income from the use of the property against which to take the allowance.

We have no quarrel with the settled principle that each year should be treated separately for income tax purposes. We do believe, however, that such principle does not extend to the point of separating related income and expense items merely because they fall in two different periods. Often, in order to correctly reflect income, ex-

penditures creating benefits extending into other years are required to be deducted over the period of benefit *(Duffy v. Central Railroad, 268 U. S. 58)*. Expenditures made in prior years are authorized as deductions against gross income received in a later year in order to properly reflect net income. This practice, as authorized by regulations, has been recognized with approval by this Court with respect to long term contracts *(Burnet, Commissioner, v. Sanford & Brooks Co., 282 U. S. 359)*. Thus it is clear that the regulation here involved, in so far as it correlates gross income and the deduction in arriving at net income, is not entirely novel.

Other examples could be cited. When bonds are sold at a discount, the taxpayer is permitted to deduct such discount ratably over the life of the bonds to date of retirement *(C. R. I. & P. Ry. Co. v. Commissioner, 47 F. (2d) 990;* certiorari denied October 12, 1931). Brokers' fees to secure a lease were spread over the term of the lease rather than charged against income of the first year—thus co-ordinating income and deduction *(Bonwit Teller & Co. v. Commissioner, 53 F. (2d) 381)*. The use of inventories, permitting cost of goods in an earlier year to be set off against sales in subsequent years, is specifically authorized in the Revenue Acts.

It has been recognized in the law that a deduction, when reasonably ascertainable, may be anticipated and taken in the year when the gross income is received. The

1928 Revenue Act authorizes the deduction of future or anticipated expenses in connection with the sales of real property *(Section 23)*. The only purpose of the above provision is to permit the deduction in the year when the gross income is received, in order to properly reflect net income.

This Court in *Lucas v. American Code Company, 280 U. S. 445*, stated:

> "Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains. Weiss v. Wiener, 279 U. S. 333, 335. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are absolutely realized. * * * The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test."

The test of practicability is met here. Indeed the Regulation appears the only practical method of correlating the income of this petitioner derived from the Oil Company with the deduction to which he is entitled under the provisions of the Revenue Act. Any other interpretation would result in distortion of income—a result far from practical.

In conclusion we desire to point out that the principle of permitting depletion deductions against bonuses or advance royalties has long been recognized. Successive Revenue Acts have been passed by Congress during the existence of such regulations. The Revenue Act of 1921

was passed during the existence of the original *Regulation 215 (a)*. The 1928 Revenue Act was passed after the amendment to the Regulation contained in *T. D. 3938* had been promulgated by the Department.

It is settled law that after the re-enactment of a statutory provision which has received a well-settled administrative construction, such construction is deemed to have been adopted by Congress, unless the contrary is clearly indicated. In the recent case of *Brewster v. Gage, 280 U. S. 327, 74 L. ed. 457*, this Court, in referring to a similar situation with respect to regulations of the Commissioner of Internal Revenue, said as follows:

> "The substantial re-enactment in later acts of the provision theretofore construed by the department is persuasive evidence of legislative approval of the regulation. National Lead Co. v. United States, 252 U. S. 140, 146, 64 L. ed. 496, 499, 40 Sup. Ct. Rep. 237; United States v. Cerecedo Hermanos y Compania, 208 U. S. 337, 339, 52 L. ed. 821, 822, 28 Sup. Ct. Rep. 532; United States v. Falk, 204 U. S. 143, 152, 51 L. ed. 411, 414, 27 Sup. Ct. Rep. 191. The subsequent legislation confirmed and carried forward the policy evidenced by the earlier enactments as interpreted in the regulations promulgated under them."

And this Court in the case of *Lucas, etc., v. American Code Co., supra*, said:

> "Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful."

II.

The decision below holding transfers of oil and gas leases providing for cash bonuses, and excess or over-riding royalties, payable in oil to be sales or assignments, and not sub-leases is contrary to and in conflict with the established law of Louisiana.

In its brief below the Government conceded that "under the applicable statutes and Treasury Department Regulations . . . a lessor, including a sub-lessor, of mining property is entitled to a deduction from income on account of depletion," which is consistent with its concession previously made in the *Waller* case *(Waller v. Commissioner, 16 B. T. A. 574)* involving the Smitherman-Ohio transaction. It logically follows that a sub-lessor would be entitled to the same benefits as a lessor, for a sub-lease is in all respects a new lease superimposed on the original lease. *Smith v. Sun Oil Co., supra.*

In this case, the Circuit Court has apparently adhered to its former rulings in *Waller v. Commissioner, 40 F. (2) 892* and *Herold v. Commissioner, 42 F. (2) 942,* holding the transfers involved to be sales or assignments, but has gone further and denied relief under a construction of the applicable Revenue Laws and Regulations, that in effect destroys the validity of the Regulation which governs this case.

The opinion of the trial Judge (R. 98) shows that his decision was rendered against petitioner on this question only because he felt bound by the earlier decisions of the Circuit Court of Appeals, for the body of the opinion

is devoted entirely to an exposition of his belief that petitioner was entitled to depletion and that the instruments involved were sub-leases and not assignments.

Subsequent to the decision in those two cases, the Supreme Court of Louisiana decided *Roberson v. Pioneer Gas Co., 173 La. 313*, which again affirms and restates the law of Louisiana respecting the transfer of oil and gas leases by sub-lease or assignment. Tested by the *Roberson* case and the jurisprudence therein reviewed, particularly *Smith v. Sun Oil Co., 165 La. 907*, the transfers involved here are indubitably sub-leases. The Circuit Court of Appeals in this case, in effect, holds the doctrine of the *Roberson* case on this point to be *obiter dictum.*

We disagree with the Circuit Court on the proposition that those expressions are *obiter*, and were not at issue in the case. In *Smith v. Sun Oil Co., 165 La. 907*, the question was whether or not drilling on part of an oil and gas lease, divisible by assignment, would inure to the benefit of the whole lease. The court held that if the transfer was a sub-lease the drilling on part would inure to the benefit of the whole; if an assignment, drilling on part would not. There the transfer was held to be a sub-lease in an opinion which is a treatise on the whole question of assignment and sub-lease. In *Roberson v. Pioneer Gas Co., supra*, following *Smith v. Sun Oil Co., supra*, the plaintiff sued for cancellation of part of a lease, divisible by assignment, on the other part of which, the transferee of the original lessee, as to part only, had drilled a well. The syllogism of the defense was: development by a sub-lessee of part of a lease, divisible by assignment, inures to the

benefit of the entire lease; this development was made by a sub-lessee; therefore, the development inured to the benefit of the entire lease.

In arriving at its conclusion that the lease should be forfeited as to the undeveloped part, it was absolutely necessary for the Supreme Court of Louisiana to dispose of the contention by either holding that development by the sub-lessee of a part of a lease did not inure to the benefit of the whole tract, or that the transferee who developed a part was not a sub-lessee. The Court squarely adhered to its doctrine in *Smith v. Sun Oil Company*, but held the transferee to be an assignee and not a sub-lessee. The court, therefore, decided a matter squarely at issue in the case, and its expression regarding transfers of leases by sub-lease and assignment was the *ratio decidendi* of the case and not *obiter*.

The Court below has attempted in its opinion to break the force of the decision in *Roberson v. Pioneer Gas Co., supra*, by saying that it was "unable to agree that the question as to what constituted a sub-lease as distinguished from an assignment was before the Supreme Court of Louisiana for decision." But for this conclusion, the Court under its previous decision in *Harrell v. United Carbon Co., 52 Fed. (2nd) 790*, would necessarily have followed the *Roberson* case because they expressly held in the *Harrell* case that the *Roberson* case had definitely established a rule of property in Louisiana which they were bound to follow under *Guffey v. Smith, 237 U. S. 101*.

We have shown that the *Roberson* case did involve the question of the distinction between assignments and

sub-leases and we insist that the court below was wrong in holding to the contrary. That case is the last of a line of cases on the same subject, and the Circuit Court of Appeals should have followed it as a definite rule of property in Louisiana.

The ruling of the Circuit Court of Appeals in these cases, starting with *Waller v. Commissioner, supra*, is pitched upon the common law distinction between sub-lease and assignment, manifestly a false premise in view of this court's opinion in *Viterbo v. Friedlander, 120 U. S. 707.* In the *Waller, Herold* and *Palmer* cases, the Circuit Court has referred to no Louisiana statute and to but one Louisiana case (and then incorrectly) to support its conclusions.

A brief comparison and discussion of Louisiana jurisprudence and the civil law doctrine will demonstrate the principles underlying *Smith v. Sun Oil Co., 165 La. 907*, and *Roberson v. Pioneer Gas Co., 173 La. 313*, and will show that the views and opinion of Circuit Court of Appeals in this case are in direct conflict with Louisiana law and jurisprudence on the points involved.

In the *Waller* case, *supra*, the Circuit Court of Appeals stated the distinction between sub-lease and assignment to be as follows:

> "An assignment of a lease occurs where a lessee parts with his entire interest in the demised premises or a part thereof for the unexpired term of the original lease. 16 R. C. L. 824, 826; 35 C. J. 988, 989. If the assignor convey less than his entire interest in the whole or a part of his lease, so that there still remains in him a reversionary in-

terest, the transaction amounts to a sub-lease. 14 R. C. L. 826."

That is the common law distinction, derived from sources which cite no Louisiana case on the subject.

In *Roberson v. Pioneer Gas Co., 173 La. 313, 137 So. 46*, decided more than a year after the *Waller* case, the Supreme Court of Louisiana stated the distinction in Louisiana to be as follows:

> "The distinction between an assignment of a lease and a sub-lease is that, in an assignment, the assignor transfers his entire interest in the lease in so far as it affects the property on which the lease is assigned; whereas, in a sublease, the original lessee, or sublessor, retains an interest in the lease in so far as it affects the property subleased—by imposing some obligation upon the sublessee in favor of the sublessor, such as an obligation to pay an additional rent to the sublessor. Robinson v. Freret, 9 La. Ann. 303; Audubon Hotel Co. v. Browning, 120 La. 1089, 46 So. 331; 124 Am. St. Rep. 456; Rev. Civ. Code, Art. 2725; Code Napoleon, Art. 1717; Baudry-Lacantiniere, Vol. 20, p. 616, No. 1052 and 1053; Beaudant, p. 374, No. 531 and 532; Marcade, Vol. 6, p. 112; Aubry et Rau, Vol. 5, p. 336."

The subject matter of the case was an oil and gas lease, and in construing it the Court said:

> "If the Pioneer Gas Company (lessee) had retained an overriding royalty, or excess royalty, to be paid by Pipes and Mack to the Pioneer Gas Company, in addition to the one-eighth royalty to be paid by Pipes and Mack to the original lessors, the contract between Pipes and Mack would have been a sub-lease and not merely an assignment of the lease

on the 40 acres of land. See Smith v. Sun Oil Company, 165 La. 907, 116 So. 379, 380, and Johnson v. Moody, 168 La. 799, 123 So. 330."

In the Common Law test adopted by the Circuit Court of Appeals the criterion is,—did the lessee retain a reversionary interest? In the Civil Law test announced by the Supreme Court of Louisiana, the distinction is,—did the lessee stipulate for a new rental? The tests are wholly incompatible.

In the *Waller* case the Circuit Court of Appeals considered the doctrine of *Smith v. Sun Oil Company, 165 La. 907*, not to be materially different from the common law test which it adopted in the *Waller* case, and said:

> "But, so far as material here, there is no difference in the rights of the lessor and the lessee under either system of law. In Smith v. Sun Oil Co., 165 La., 907, 116 So. 379, the conveyance in question was held to be a sublease instead of an assignment, but it was said that the lessor had not disposed of all its rights under the original lease, but had granted an interest less than its own and imposed obligations under penalty of reversion, among which were provisions to the effect that the rights of the lessor should revert to and revest in the lessor whenever the lessee should cease to develop the lease."

In direct opposition to that view, in *Roberson v. Pioneer Gas Co., supra*, the Supreme Court of Louisiana said:

> "In Smith v. Sun Oil Co. and in Johnson v. Moody, supra, we said that the obligation to pay an overriding royalty, in the contract which, in each of those cases, the parties called an assignment, was imposed upon the so-called assignee 'under penalty

> of reversion' to the original lessee, or sublessor; but we did not use the term 'reversion' in the technical sense in which it is used at common law. The reversion which we had in mind was merely the reversion of the right of occupancy or use of the property; because a contract of lease under the civil law, unlike the common law in that respect, does not convey to the lessee, temporarily, a title to the property leased, but conveys only the right to the use or enjoyment of the property. Rev. Civ. Code, Arts. 2669, 2674; Logan v. State Gravel Co., 158 La. 105, 103 So. 526."

The stipulation for a new rent at common law does not characterize the transfer of a lease as a sub-lease. *16 R. C. L. 827; 35 C. J. 990.*

The two tests cannot be reconciled. The Common Law test does not recognize the stipulation for a new rent (the basis of the Civil Law distinction), and Louisiana has definitely rejected the Common Law test of the reservation of a reversion.

The Circuit Court of Appeals has rejected the view that *Logan v. State Gravel Co., 158 La. 105,* and *Board of Commissioners v. Pure Oil Co., 167 La. 801,* sustain the proposition that in Louisiana royalty under an oil and gas lease is rent, saying that royalty under an oil and gas lease is not always rent, but may be part of the purchase price.

The Supreme Court of Louisiana, in the *Roberson v. Pioneer Gas Co.* case, takes a diametrically opposite view of that jurisprudence. We quote from that opinion:

> "The reason why an obligation to pay an overriding royalty, or excess royalty, in a transfer of a

> lease, in whole or in part, and even though the transaction be called an assignment or a sale of the lease, characterizes the transaction as a sub-lease, and not merely an assignment, is that, in oil and gas leases, under the settled jurisprudence of this state, the payment of a royalty is the payment of rent, and is not the payment of a price for the oil or gas rights, as if they were sold. See Spence v. Lucas, 138 La. 763, 70 So. 796; Logan v. State Gravel Co., 158 La. 105, 103 So. 526; Board of Commissioners of Caddo Levee District v. Pure Oil Co., 167 La. 801, 120 So. 373."

This is the last expression of the Supreme Court of Louisiana on the subject, and is the re-statement of a doctrine which has been announced in every case in which that Court has had to consider the nature of royalty.

The Circuit Court of Appeals has sought to distinguish *Logan v. State Gravel Co.*, and *Board of Commissioners v. Pure Oil Co.*, both *supra*, from the case here, on the supposition that no consideration other than royalty was stipulated in either of those cases. It affirmatively appeared that a bonus was paid in *Board of Commissioners v. Pure Oil Co.;* and it is moreover the settled law of Louisiana that an oil and gas lease must be supported by a serious consideration, or an absolute obligation to drill, the obligation to pay royalty, when and if produced, unsupported by other serious considerations, being insufficient consideration for a lease. The jurisprudence on that point is noted in *Cali v. National Linen Service Corporation, 38 F. (2) 35.*

The Circuit Court of Appeals also construed the *Logan* and *Board of Commissioners* cases to hold that the

royalty in each case was rent, because the relationship of landlord and tenant existed.

In *Logan v. State Gravel Co., supra,* the Supreme Court of Louisiana held the relationship of landlord and tenant to exist because the royalty was rent; and in *Board of Commissioners v. Pure Oil Co., supra,* that Court applied the prescription relating to the arrearages of rent, in an action for unpaid royalties under an oil and gas lease, because the royalty was rent.

The only other reference made by the Circuit Court of Appeals to Louisiana jurisprudence is to be found in *Herold v. Commissioner, 42 F. (2) 942,* where it is said ". . . and *Wilkins v. Nelson, 155 La. 807, 99 So. 607,* also holds that royalty may form a part of the consideration paid for mineral rights". That case is not authority for the proposition that royalty may form part of the purchase price of a sale. The contract involved provided for a cash consideration of $900.00 and a royalty of one-eighth of the oil. In *Wilkins v. Nelson, 161 La. 439,* the Supreme Court of Louisiana, referring to the same contract, said "At the outset, it may be well to note that the mineral contract in question was declared to be a lease in *Wilkins v. Nelson, 155 La. 810; 99 So. 607. . . .*"

In its opinion below, the Circuit Court of Appeals referred to its decision in *Pugh v. Commissioner, 49 F. (2) 76.* We are not able to see the applicability of that case to the one now before this court. The parties in the Pugh transaction were dealing with their property from an entirely different point of view. In that case the taxpayer,

Pugh, had previously executed an oil and gas lease, affecting his property in Louisiana. Subsequently he sold one-half of his royalty in language quoted by the court as follows:

> "Omitting the formal and descriptive parts and italicizing significant words, it reads: 'J. C. Pugh has this day sold to J. M. Eastham . . . one-half of his one-eighth royalty on the following property. . . . This sale and transfer is made for the price and sum of $250,000.00; $50,000.00 of which is paid in cash and the balance of $200,000.00 is to be paid out of one-half of the royalty herein conveyed to the said Eastham, the said Pugh to receive the entire royalty of one-eighth until the said unpaid balance of $200,000.00 has been paid out of the one-half belonging to the said Eastham, and thereafter, the said one-half shall be paid to the said J. M. Eastham and his assigns. . . .'"

Clearly, what Pugh transferred was one-half of his right to receive rent under an oil and gas lease previously executed with some other person. The thing sold or assigned was royalty, and not a lease and the price was a fixed and certain sum of money to be paid in cash and out of oil. A lease was not the subject matter of the transfer.

In the case here before the court, the Circuit Court of Appeals has followed its former decisions and said that the overriding royalty was part of the purchase price. This conflicts with the provisions of *Articles 2439, 2464 and 2671 of the Revised Civil Code of Louisiana*, which provide, in part, as follows:

> "*Article 2439.* The contract of sale is an agreement by which one gives a thing for a price in current money, and the other gives the price in order to have the thing itself."

"*Article 2464.* The price of the sale must be certain, that is to say, fixed and determined by the parties.

It ought to consist of a sum of money, otherwise it would be considered as an exchange."

"*Article 2671.* (Under Title IX, of Lease). The price should be certain and determined by the parties, and should consist of money. However, it may consist in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased."

The doctrine of *Logan v. State Gravel Co., supra,* is founded on this distinction. The Supreme Court of Louisiana in that case said:

> "But there are two ways in which that incorporeal right may be dealt with, viz: (1) It may be sold outright as may a 'servitude' or any other incorporeal thing (R.C.C. 2449), or (2), the land may be leased for mining purposes for a fixed rental or on a royalty basis (R.C.C. Art. 2671)."

It may be well to note that the Smitherman-Ohio sub-lease required the sub-lessee to pay over and deliver "the equal one-eighth (1/8) of oil produced and saved from the above described premises as an excess royalty" (R. 33); and the Baird-Gulf sub-lease required the sub-lessee to deliver to Baird "one twenty-fourth royalty out of oil . . . until the expiration of three years from this date, and a royalty of one thirty-second of all oil that may be saved from that produced after said date . . . " (R. 317).

The failure of the sub-lessees to pay these overriding royalties would have given the sub-lessors the right to

peremptorily cancel the sub-leases. *R.C.C. 2712* and *Louisiana Oil Refining Corporation v. Cozart, 163 La. 90.*

The trial court found as a fact that it was the intention of the parties to the Smitherman-Ohio transaction to effect a sub-lease. (Record 49).

Under the Civil Code of Louisiana, and the interpretative jurisprudence of the Supreme Court of Louisiana, the excess royalties involved in this case could only be rent, and being rent, the transfers could only be sub-leases.

CONCLUSION.

The decision of the Court of Appeals as we have shown in effect disapproves of Art. 215 (a) of the Regulations of the Department as amended by Treasury Decision 3938. The regulation is reasonable and proper and should not be interfered with unless clearly unlawful. In its disapproval of the regulation, the opinion of the court of Appeals is in direct conflict with the decision of the Ninth Circuit in the *Murphy Oil Co.* case *(55 F. (2d) 17)* thereby causing great uncertainty and confusion in the administration of the income tax laws. The question is one which apparently has never been decided by this court and in view of the existing conflict should be reviewed and settled.

The decision of the Circuit Court of Appeals is also in conflict with the jurisprudence of the State of Louisiana. The Circuit Court of Appeals has held that the transfers from Smitherman to the Ohio Oil Co. and from Baird to

the Gulf Refining Co. were sales or assignments and were not sub-leases. In its decision, the court has ignored the finding of the District Court that the transfers were Louisiana contracts governed by Louisiana law and has disregarded the decisions of the Supreme Court of Louisiana holding that such contracts are sub-leases and not sales or assignments. In so holding, the Circuit Court of Appeals has decided a question of local law contrary to the settled jurisprudence of the State of Louisiana.

We respectfully submit that this petition should be granted in order that this Honorable Court may review the questions herein presented and in due course reverse the decision of the Circuit Court of Appeals.

Respectfully submitted,

FRED R. ANGEVINE,
JOHN H. TUCKER, JR.,
HENRY P. DART,
HENRY P. DART, JR.,
Attorneys for E. G. Palmer, Petitioner.